

TEACHERS' RETIREMENT BOARD

REGULAR MEETING

SUBJECT: Update on Federal Legislation

ITEM NUMBER: 7b

ATTACHMENT(S): 1

ACTION: X

MEETING DATE: May 2, 2002

INFORMATION: _____

PRESENTER: Ed Derman

SUMMARY

Congressional activity is beginning on legislation in reaction to the problems raised by the Enron meltdown. The proposals being evaluated are discussed in more detail in the attached report.

Pension Security Legislation

- **House Legislation**

On April 11, the House of Representatives passed the first piece of legislation by approving H.R. 3762 (the "Pension Security Act of 2002"). This measure incorporates competing versions of the legislation produced by the House Ways and Means Committee and the Education and Workforce Committee. Among the areas covered in the legislation is

- Investment education and benefit statements
- Blackout notices
- Fiduciary duties during blackout periods
- Parity for employees during blackouts
- Diversification of employer securities
- Investment advice

- **Senate Legislation**

The Senate is moving more slowly than the House on this issue. In the Senate, pension jurisdiction is split between the Finance Committee, which handles tax legislation, and the Health, Education, Labor, and Pensions Committee, which is responsible for ERISA issues. Senate pension efforts seem to be less coordinated between the two Committees, as Labor Committee Chairman Edward Kennedy (D-Mass) already has moved ahead with the introduction and mark-up of S. 1992. S. 1992 addresses employer stock matches and employer stock investment, pension statements, blackouts and employee participation as trustees in individual account plans. Meanwhile, the Finance Committee continues to hold hearings on pension protection.

Investor Protection and Accounting Oversight Legislation

- **House Legislation**

Investor protection/accounting oversight jurisdiction is shared between the House Financial Services Committee, chaired by Rep. Michael Oxley (R-Ohio), and the House Energy and Commerce Committee, chaired by Rep. Billy Tauzin (R-La.). Although Speaker Hastert has been urging these two Chairmen to work together on such legislation, Chairman Oxley has pursued his own measure, while Chairman Tauzin is still considering his options.

On April 11, the House Financial Services Committee held a mark-up on Chairman Oxley's legislation, but was forced to continue the mark-up over to April 16 after Democrats filed nearly four dozen amendments seeking to make various provisions more stringent. Chairman Oxley's proposal, H.R. 3763, is known as the "Corporate and Auditing Accountability, Responsibility, and Transparency Act". The measure would make numerous changes in the regulation of the accounting profession as well as providing for enhanced corporate disclosure to investors.

- **Senate Legislation**

In the Senate, jurisdiction over investor protection and accounting oversight is more consolidated in the Banking Committee, chaired by Sen. Paul Sarbanes (D-Md.), with the Commerce Committee having a more limited role. Chairman Sarbanes is expected to put together his investor protection-accounting oversight proposal in the next several weeks, using as a starting point the package developed by Sens. Chris Dodd (D-Conn.) and Jon Corzine (D-N.J.). The Dodd-Corzine proposal, S. 2004, is known as "The Investor Confidence in Public Accounting Act of 2002", which concerns federal regulation of accounting, treatment of stock options on financial statements and financial disclosures.

Securities Fraud Litigation Legislation

- **Senate Legislation**

The remaining area of potential legislative action as a result of Enron involves potential changes in conducting securities fraud litigation. Senate Judiciary Committee Chairman Patrick Leahy (D-Vt.) and Senate Majority Leader Tom Daschle (D-S.D.) have introduced S. 2010, the "Corporate and Criminal Fraud Accountability Act of 2002".

The Leahy-Daschle proposal provides additional tools for prosecutors to pursue fraud cases and for regulators and investigators to collect and preserve evidence of fraud. It also provides for additional tools for victims of fraud to recover compensation from those

who perpetrated and aided the fraud. Finally, it strengthens the criminal and civil sanctions for fraudulent activity.

This legislation has not been moving in the Senate, although Chairman Leahy can move forward on the legislation in Committee mark-up as soon as he desires. No serious legislative counterpart to Sen. Leahy's proposal has emerged in the House.

Elk Hills Compensation

The California State Teachers' Retirement System (CalSTRS) is continuing to coordinate with House Ways and Means Committee Chairman Bill Thomas (R-Bakersfield) and Sen. Dianne Feinstein (D-Ca.), to pursue the necessary Congressional appropriation of the fifth \$36 million installment of Elk Hills compensation due for FY 2003.

Testimony reviewed and approved by CalSTRS staff was filed with the House Interior Appropriations Subcommittee, which will be the first venue for the Elk Hills appropriations issue, and have now filed counterpart testimony with the Senate Interior Appropriations Subcommittee. CalSTRS is also continuing to coordinate with the Governor's office in Washington in this legislative effort.

CalSTRS has been working intensively to persuade the entire 52 Member California House delegation to sign on to a letter to the House appropriators in strong support of the appropriation for the fifth installment of Elk Hills compensation. CalSTRS hopes to complete the letter with all 52 Members signing on and get it in to the Congressional appropriators next week.

Mr. Derman will provide a verbal update at the meeting.

**MEMORANDUM FOR
THE CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM**

Washington Monthly Report

Pension Security Legislation

House Legislation

On April 11, the House of Representatives passed the first piece of legislation responding to the Enron debacle by adopting a pension security package, H.R. 3762 (the "Pension Security Act of 2002). This legislation melded together competing versions of the legislation produced by the House Ways and Means Committee, chaired by Rep. Bill Thomas (R-Bakersfield), and the Education and Workforce Committee, chaired by Rep. John Boehner (R-Ohio). The legislation now moves to the Senate, which is proceeding more slowly in putting together a single Senate pension security package.

The key features of this pension security legislation are as follows:

Investment Education and Benefit Statement:

- The bill requires the plan administrator to provide a quarterly notice to plan participants and beneficiaries of the value of investments allocated to their individual account, including their rights to diversify any assets held in employer securities.
- The notice will also include an explanation of the importance of a diversified investment portfolio including a risk of holding substantial portions of a portfolio in any one security, such as employer securities.
- The Secretary will issue guidance and model notices that include the value of investments, the rights of employees to diversify any employer securities and an explanation of the importance of a diversified investment portfolio. Initial guidance will be no later than January 1, 2003. The Secretary may also issue interim model guidance.
- Notice may be electronic if reasonably accessible to the recipient.

Blackout Notices:

- The bill requires a new notice 30 days prior to any suspension of participant and beneficiaries ability to direct or diversify assets. The notice must contain the reasons for the suspension, as well as a statement that the administrator has evaluated the reasonableness of the expected period, and a statement that the participant should evaluate the appropriateness of their current investment decisions in light of their inability to direct or diversify assets during the expected period of suspension.
- The bill requires that plan administrators shall determine prior to distributing notice that any suspension, limitation or restriction is reasonable.
- The bill clarifies that notice is required only for suspensions longer than three consecutive calendar days and provides for specific exceptions to the 30 day rule. In the event of a qualified domestic relations order, or a blackout period caused by a merger or acquisition, only those employees who are impacted by the event will receive the notice.
- The bill provides that the Secretary shall issue guidance and model notices that include the above factors and such other provisions the Secretary may specify. Initial guidance will be no later than January 1, 2003. The Secretary may issue interim model guidance.
- The bill clarifies that notice may be electronic if reasonably accessible to the recipient.
- The bill provides that the Secretary may provide for additional exceptions to the requirements that are in the interest of participants and beneficiaries.

Inapplicability of Relief from Fiduciary Liability During Suspension of Ability of Participants to Direct Investments

- The bill explains fiduciary duty during blackout period. It clarifies that fiduciaries are not liable for losses provided that fiduciaries satisfy the requirements of this title.
- Relevant considerations in determining the satisfaction of fiduciary duty are also added, such as the provision of the blackout notice, the fiduciary's consideration of the reasonableness of the period of suspension, and the fiduciary's actions solely in the interest of participants and beneficiaries.

Diversification:

- The bill ensures that all employee contributions to pension plans will be immediately diversifiable.

- The bill provides for a five year transition rule for the allowable diversification of employer securities held in individual account plans as of the date of enactment.
- The bill provides for the option of a rolling three-year diversification of employer securities. In this case employer securities may be diversified three years after the calendar quarter in which they were contributed.
- The bill exempts individual account plans that do not hold employer securities that are readily tradable on an established securities market.

Investment Advice:

- The bill includes the text of H.R. 2269, the Retirement Security Advice Act, which provides increased availability of investment advisors to assist plan participants in making good decisions about their retirement assets.
- Employees will also be able to use pre-tax dollars to obtain their own investment advice.

Parity for Employees During Blackouts:

- The bill amends Section 16 the Securities and Exchange Act of 1934 to prohibit company executives and insiders from purchasing or selling any employer securities while plan participants and beneficiaries are precluded from directing or diversifying their accounts during a "blackout" period.

We have been coordinating with the informal working group of State and local government organizations in working with Congressional staff to clarify several technical aspects of these provisions, including making clear that the new notice and diversification provisions apply only to plans with self-directed accounts, not all plans that maintain accounts.

Senate Legislation

The Senate is moving more slowly in addressing the pension security issue. In the Senate, pension jurisdiction is split between the Finance Committee, chaired by Sen. Max Baucus (D-Mont.), which handles the tax side, and the Health, Education, Labor, and Pensions Committee, chaired by Sen. Edward Kennedy (D-Mass.), which handles the ERISA side. Senate pension efforts seem to be less coordinated between the two Committees, as Chairman Kennedy already has moved ahead with introduction and mark-up of legislation while the Finance Committee continues to hold hearings on pension protection.

a. Senate Labor Committee package

Late last month, the Senate Health, Education, Labor, and Pensions Committee, chaired by Sen. Edward Kennedy (D-Mass.), reported out its version of pension security legislation (S. 1992) on a sharply-divided party line vote.

The Senate Labor Committee measure would permit continued use of employer stock matches and of company stock as an investment option, but not both. Employer requirements that plan assets be invested in employer stock would be barred.

Plan sponsors could designate independent investment advisors for participants, in accordance with certain guidelines. Pension benefit statements would be required on a quarterly basis.

The plan sponsor and plan administrator would have a new fiduciary duty under ERISA to provide each participant who exercise control over assets in his or her account with "all material investment information regarding investment of such assets to the extent that such information is generally required to be disclosed by the plan sponsor to investors in connection with an investment under the applicable securities laws."

The plan fiduciary could be sued under ERISA for breach of fiduciary duty. The fiduciary of an individual account plan having more than 100 participants would have to provide adequate insurance coverage for failure to comply with fiduciary duties. Liability for breach of fiduciary duty would be extended to other persons who participate in or conceal such breach.

Thirty days written notice would have to be provided in advance of any "lock-down", which could not continue for an unreasonable period of time.

Insider stock transactions would have to be disclosed promptly in electronic form.

Finally, in a significant and likely controversial change to ERISA, the Senate Labor Committee proposal requires that a single employer plan which an individual account plan covering more than 100 participants must be governed by a board of trustees, half of whom shall represent employer interests and half shall represent participant interests. In the case of collectively-bargained plans, the trustees representing employee interests are to be determined by election in which all participants may participate.

b. Senate Finance Committee proposal

There still isn't one yet. Senate Finance Committee Chairman Max Baucus (D-Mont.) has been conducting more hearings before moving forward with a pension security proposal. The Republican and Democratic staffs have been meeting in an effort to develop a bipartisan pension package. Chairman Baucus hopes to introduce legislation before Congress leaves for the Memorial Day recess at the end of May.

Since the Finance Committee – as opposed to Sen. Kennedy's Committee – has jurisdiction over the pension tax rules that most directly affect STRS and other governmental plans, a potential Finance Committee pension bill is of greatest interest. The Finance Committee's tradition of bipartisanship, coupled with the close partisan split in the Senate, are likely to limit the adoption of controversial pension changes.

Investor Protection and Accounting Oversight Legislation

House Legislation

As noted in last month's report, on the investor protection/accounting oversight front, jurisdiction is shared (and to some extent battled over) between the House Financial Services Committee, chaired by Rep. Michael Oxley (R-Ohio), and the House Energy and Commerce Committee, chaired by Democrat turned Republican Rep. Billy Tauzin (R-La.). Speaker Hastert has been urging these two Chairmen to work together on investor protection/accounting oversight legislation, but at least for now Financial Services Chairman Oxley has forged ahead with his own measure. Energy and Commerce Chairman Tauzin is still mulling over his options.

The House Financial Services Committee held a mark-up on Chairman Oxley's investor protection-auditor oversight legislation on April 11, but was forced to continue the mark-up over to April 16 after Democrats filed nearly four dozen amendments seeking to make various provisions more stringent.

Chairman Oxley's legislation – which was described in last month's report – is known as the "Corporate and Auditing Accountability, Responsibility, and Transparency Act" (H.R. 3763). The legislation would make a number of changes in the regulation of the accounting profession as well as providing for enhanced corporate disclosure to investors.

On the accounting side, the measure would prohibit accounting firms from providing internal auditing and financial computer systems consulting services to their audit clients – though the lucrative tax consulting services could continue. A new "public" regulatory board would be established to oversee the accounting profession. This new regulatory board would be "public" in the sense that two-thirds of the board would be comprised of persons not associated with the accounting profession and would operate under the "direct authority" of the Securities and Exchange Commission. Accountants and their firms would be subject to "certification" by this new board and would have statutory authority to impose penalties on accountants who violate securities laws or standards of ethics, competency, or independence.

On the corporate disclosure side, the measure would require that off-balance sheet transactions be "fully disclosed". Corporate insiders would be required to inform the SEC and the public within a 1-2 day period after they sell company stock, rather than waiting up to 40 days under current law. Public companies would be required to make public disclosure "on a rapid and essentially contemporaneous basis, of information concerning the issuer's financial health and operations." It also would be made unlawful for any person associated with the

company to "interfere" with the auditing process. The SEC would be required to conduct regular and thorough audit reviews of the largest and most widely traded companies. Finally, the legislation would require a number of studies, including stock analyst conflict of interest, corporate information disclosure, role of credit rating agencies, and corporate governance.

Democrats offered a slew of amendments seeking to toughen various aspects of Chairman Oxley's package. These Democratic amendments would have: spelled out in statute the standards that the new accounting industry oversight board would apply, rather than leaving it to the board to develop such standards; mandated that the new board be funded by an industry assessment on public companies, rather than leaving it to the board to determine; strengthened the enforcement and investigative authority of the board; and required independent audit quality reviews by a second accounting firm having no relationship with the client.

The Committee did adopt a GOP amendment providing that the accounting oversight board would have five members consisting of three "public" members unaffiliated with the accounting profession and two accountants. A subsequent GOP amendment approved on a party line vote eroded the independence of the "public" members of the board by providing that former accountants who had been out of the profession for two years would be eligible for two of these "public" slots.

Also defeated were Democratic amendments that would have implemented President Bush's proposal to require corporate officers to personally attest to the accuracy and fairness of the corporation's financial disclosures and that would have required the Securities and Exchange Commission (SEC) to strip corporate officers and directors of salaries and bonuses if they were found to have made intentionally misleading statements about the corporation's finances. The Committee also defeated an amendment to more closely scrutinize stock analysts' conflicts of interest.

The Committee did accept a Democratic amendment to bar the securities exchanges from listing a corporation that did not have a corporate code of ethics, as well as requiring publicly-traded corporations to notify the public and the SEC of any changes to such code of ethics.

Finally, the House Committee authorized a 60 percent increase in the SEC's FY 2003 budget, to \$776 million. This budget increase, however, is subject to funding by the Congressional appropriators.

Senate Legislation

On the Senate side, jurisdiction over investor protection and accounting oversight is more consolidated in the Banking Committee, chaired by Sen. Paul Sarbanes (D-Md.), with the Commerce Committee, chaired by Sen. Ernest Hollings (D-S.C.), having a more limited role. Chairman Sarbanes is expected to develop legislation using as a starting point the package developed by Sens. Chris Dodd (D-Conn.) and Jon Corzine (D-N.J.) that was described at length in last month's report. The Dodd-Corzine proposal is known as "The Investor Confidence in Public Accounting Act of 2002" (S. 2004).

In brief, the Dodd-Corzine legislation would:

- create a new regulatory board to oversee the accounting profession, including reviewing audit quality and auditing standards;
- double the size of the Securities and Exchange Commission accounting staff;
- restrict accounting firms from providing both auditing and non-audit services at the same time to a client;
- limit the "revolving door" of between accounting firms and corporate clients by barring an accounting firm from providing public audit services to a corporate whose chief financial officer or controller had worked for such accounting firm in the previous two years;
- improve the transparency of financial disclosures;
- require the SEC to make recommendations regarding the appropriate financial statement treatment of stock options and conditions under which special purpose entities should be consolidated; and
- direct "self-regulatory" organizations – national securities exchanges, registered securities associations, and registered clearing agencies – to each conduct a study of corporate governance standards and practices to determine whether such standards and practices are in the best interests of shareholders.

Senate Banking Chairman Sarbanes is expected to put together his investor protection-accounting oversight package in the next several weeks.

Securities Fraud Litigation Legislation

As reported last month, the remaining area of potential legislative activity in the wake of Enron involves possible changes to the conduct of securities fraud litigation. Senate Judiciary Committee Chairman Patrick Leahy (D-Vt.) and Senate Majority Leader Tom Daschle (D-S.D.) have introduced S. 2010, the "Corporate and Criminal Fraud Accountability Act of 2002".

Chairman Leahy's proposal has three principal components:

- (1) additional tools for prosecutors to pursue fraud cases;
- (2) additional tools for regulators and investigators to collect and preserve evidence of fraud; and
- (3) additional tools for victims of fraud to recover compensation from those who perpetrated and aided the fraud.

The legislation would supplement the current patchwork of technical securities law violations with a more general and less technical provision, comparable to bank fraud statutes. The provision would create a new felony, punishable by up to 10 years in prison, for defrauding shareholders of publicly traded companies. State attorneys general and the SEC would now be authorized, along with the U.S. Attorney General, to bring civil RICO actions with treble damages for securities fraud. In addition, sentencing guidelines would be made more stringent for fraud cases in which evidence was destroyed or fabricated, large numbers of investors were harmed, or where the harm to investors was particularly grave. The measure would make it a crime to destroy evidence in a federal investigation of a securities fraud case involving a publicly-traded company.

This legislation would extend the period of limitations for securities fraud cases brought by investors against public corporations to the earlier of five years after the date of the fraud or three years after the fraud was discovered. The measure also would limit the ability of those who have committed securities fraud to use the shield of bankruptcy against investor suits. Finally, new "whistleblower" protections would be provided for employees of public companies in connection with disclosure of fraud to regulators.

There has been no movement on this legislation in the Senate since our last report, although its sponsor Sen. Leahy, as Chairman of the Committee, is in a position to move forward on the legislation in Committee mark-up as soon as he desires. Thus far, no serious legislative counterpart to Sen. Leahy's proposal has emerged in the House.

Elk Hills Compensation

We are continuing our year-long effort, working with our House champion, House Ways and Means Committee Chairman Bill Thomas (R-Bakersfield) and our Senate champion, Sen. Dianne Feinstein (D-Ca.), to pursue the necessary Congressional appropriation of the fifth \$36 million installment of Elk Hills compensation due for FY 2003.

We have filed testimony reviewed and approved by STRS staff with the House Interior Appropriations Subcommittee that will be the first venue for the Elk Hills appropriations issue and have now filed counterpart testimony with the Senate Interior Appropriations Subcommittee. We also are continuing to coordinate with the Governor's office in Washington in this legislative effort.

Over the last several weeks, we have been working intensively to persuade the entire 52 Member California House delegation – which can only be described as "disparate" in nature – to sign on to a letter to the House appropriators in strong support of the appropriation for the fifth installment of Elk Hills compensation. We are almost there, but not quite, with about nine Members still outstanding. We hope to complete the letter with all 52 Members signing on and get it in to the Congressional appropriators next week. Once again, Rep. Thomas's leadership on this issue has been invaluable, and we are particularly grateful for his active help given his time-consuming, high stakes duties as Chairman of the House Ways and Means Committee, which handles tax, pension, health, trade, and welfare legislation for the House of Representatives.

John S. Stanton

Washington, D.C.
April 12, 2001